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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-9

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NATIONAL ALFALFA DEHYDRATING AND MILLING COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. A 18–41)[1] is reported at 57 T.C. 46. The opinion of the court of appeals (Pet. App. B 42–69) is reported at 472 F.2d 796.

JURISDICTION

The judgment of the court of appeals (Pet. App. C 70–71) was entered on January 26, 1973. On April 18, 1973, Mr. Justice White extended the time for filing a

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[1] "Pet. App." references are to the appendices to the petition for certiorari.

petition for a writ of certiorari to and including June 25, 1973, and the petition was filed on that date. The petition was granted on October 9, 1973 (R. 224).[2] This Court's jurisdiction rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether respondent's recapitalization through the issuance of 5 percent debentures in the face amount of $50 for each share of outstanding $50 par 5 percent cumulative preferred stock gave rise to a $17 deduction for amortizable bond discount for each debenture issued, reflecting the difference between the face amount of the debentures and the market value ($33 per share) of the eliminated preferred stock.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 163 and 1232 of the Internal Revenue Code of 1954, and of Treasury Regulations on Income Tax (1954 Code), §§ 1.61–12 (as effective in 1957) and 1.163–3 (effective since 1968) are set forth in the Appendix, *infra*, pp. 37–40.

STATEMENT

In July 1957, in addition to an issue of $1 par common stock, respondent had outstanding 47,059 shares of $50 par, 5% cumulative preferred stock, on which there were dividend arrearages of $10 per share (R. 25). These preferred shares were normally redeemable in whole or in part at the discretion of the board of directors, or through the operation of a sink-

[2] "R." references are to the separately bound record appendix.

ing fund,[3] at a price which was, in 1957, $51 per share plus accrued dividends. Any preferred shares redeemed could not be reissued, but had to be cancelled or retired (R. 192, 196). When, however, there were dividend arrearages on the preferred shares, there were restrictions upon the acquisition and retirement of such stock in transactions with individual shareholders.[4] Upon voluntary liquidation of the corporation, holders of the preferred shares were entitled to $50 per share, plus accrued dividends, prior to any distribution to common shareholders (R. 196).

On April 8, 1957, respondent's board of directors adopted resolutions which proposed "a reorganization of the Company by way of recapitalization." The board proposed a three-step plan. First, an amendment of the certificate of incorporation to (a) eliminate the preferred shares as of August 1, 1957; (b) increase the par value of the common shares from $1 to $3 and increase their authorized number from 763,000 to 1,000,000; and (c) authorize the issuance of warrants for the purchase of common stock. Second,

[3] The sinking fund provisions (R. 193–196), operative after September 1, 1948, required that 20 percent of consolidated net earnings (after the payment of dividends on the preferred shares then outstanding) should be set aside and employed for the redemption of preferred shares as long as there were any preferred shares outstanding.

[4] Preferred shares could not be purchased, redeemed, or otherwise acquired for value at any time while there were dividend arrearages thereon unless the holders of 50 percent of the preferred shares consented, or unless the corporation notified all preferred shareholders of its desire to purchase such preferred shares and invited tender offers (R. 199, 201).

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the plan called for the issuance under an indenture of 5% debentures due July 1, 1975 in the principal amount of $2,352,950. The holder of each share of the $50 par 5% cumulative preferred stock to be eliminated would receive one of the newly-issued debentures in the face amount of $50. Third, the board proposed the issuance to the preferred shareholders of a warrant to purchase one-half of a share of common stock at the price of $10 per share in lieu of the dividend arrearages (R. 25, 53, 56–59).

Following stockholder approval of all three aspects of the plan at the annual meeting,[5] the outstanding cumulative preferred stock was eliminated and cancelled as of August 1, 1957. The holder of each share of the eliminated $50 par 5% cumulative preferred stock received a 5% debenture in the face amount of $50 payable July 1, 1975. Each received also a warrant to

[5] A proxy statement (R. 173, 176–181) which accompanied the notice of the proposals to the shareholders (R. 172) explained them in greater detail, and summarized the principal provisions of the indenture under which the debentures were to be issued, including provisions for subordination, redemption, and a sinking fund.

Specifically, the debentures were to be subordinate to bank loans for inventory purposes and to obligations to suppliers of materials, services and labor in the normal course of business (R. 100). They were redeemable in whole or in part, and from time to time, after July 1, 1958, at par, plus accrued interest to date of redemption (R. 97–100). The sinking fund provision required respondent, after April 30, 1959, to set aside annually, for redemption of debentures at par plus accrued interest, the lesser of either the sum sufficient to redeem $196,080 face amount of debentures or 100% of the consolidated net earnings for the fiscal year, with the proviso that if the latter alternative were applicable for any year the fixed figure should be deemed cumulative (R. 100–102).

subscribe to one-half share of common stock at a price of $10 per share in lieu of dividend arrearages (R. 25, 172). Respondent's books reflected this transaction by debiting the preferred stock account for the $2,352,950 par amount eliminated and crediting the liability account for 18-year 5% debentures with $2,352,950 (R. 26. 157–158).

During the latter half of July 1957, bid prices for respondent's preferred stock ranged from a low of 29 to a high of 33, and offering prices ranged from a low of 32 to a high of 35 (R. 27, 161, 163–167). On its income tax returns for fiscal years ended April 30, 1958 through 1967, respondent claimed deductions for bond discount asserted to have been created upon the issuance of its $50 debentures. The alleged discount was measured by the differences between the asserted market value of $33 for each share of the eliminated preferred stock and the $50 face amount of each debenture issued in lieu of a share of the preferred stock. The deductions in earlier years were included in losses carried over to fiscal 1967. The Commissioner of Internal Revenue disallowed a deduction of $109,804 for bond discount for 1967, and $321,657 of claimed loss carryovers from prior years by virtue of deductions for bond discount claimed in those years, and asserted a deficiency for 1967 (R. 13–16, 27–28).

The Tax Court, in a unanimous reviewed decision, upheld the deficiency asserted by the Commissioner. The Tax Court's opinion adopted the reasoning of recent decisions of the Court of Claims which have held that when a corporation issues its obligations for or in lieu of its own previously outstanding preferred

stock or bonds, no discount can arise upon the issuance of the obligations if the amount received upon the issuance of the original securities was equal to the face amount of the obligations issued in exchange. Under those circumstances, the Court of Claims deemed irrelevant the market value of the original securities at the time of the exchange (Pet. App. A 18, 27–41). The court of appeals reversed, with one judge dissenting. It held that the issuance of each $50 debenture gave rise to $17 of discount, represented by the difference between the $50 face amount of the debenture and the market value ($33 per share) of the preferred stock (Pet. App. B 42–69).

SUMMARY OF ARGUMENT

A

If a corporation issues a ten-year bond in the face amount of $1,000 for $950, the $50 difference is an additional cost of borrowing known as discount, which is deductible in the amount of $5 per year over the term of the bond. Although the Internal Revenue Code and its predecessor Revenue Acts have never explicitly provided for a deduction for bond discount, the Treasury Regulations since 1918 have authorized amortization and deduction of bond discount, where it exists, over the term of the bond. The early Regulations referred to discount as loss, and this Court's early decisions referred to discount both as loss and as interest, without distinction. More recently, however, the Court has been explicit in recognizing discount as serving the function of interest, and the current

Regulations treat it under Section 163, which allows a deduction for interest paid or accrued.

The question in this case is whether respondent became entitled to deductions for bond discount upon the issuance of 5% debentures in the face amount of $50 in substitution for its previously outstanding shares of $50 par, 5% preferred stock. Contrary to decisions of the Court of Claims, the court of appeals found discount equal to the difference between the face amount of the debenture ($50) and the market price of the preferred stock ($33) as of its retirement. In identical transactions, the Court of Claims has explicitly held that the market value of the preferred stock is irrelevant.

In order for discount to exist, there must be an outlay, or an obligation to make an outlay, in excess of the amount of borrowed capital. Here there was neither the requisite outlay nor the obligation. All that occurred was a simple capital readjustment in the form of a recapitalization with no obligation to pay out more than the capital received. Under these circumstances, there was no basis for the existence of discount.

Moreover, if the stock were retired for cash, no deduction woud be available either for the par value of the stock for any call or redemption premium, or because the stock was retired for a greater amount than the issue price. The substitution of an interest-bearing obligation in the face amount of the cash that otherwise would have been paid should not produce a deduction for discount.

B

The decision of the court below rests upon two erroneous analogies. First, the court assimilated the transaction to one where bonds are issued for property. The question whether discount arises when bonds are issued for property has been the subject of some judicial disagreement, although it has been settled legislatively for years after 1969. However, because the retirement of stock is not the acquisition of property, the analogy is inapposite. There is consequently no need to reach the bonds-for-property question in the resolution of this case.

Secondly, the court below assimilated the transaction to one where respondent issued $50 face amount bonds for $33 and thereafter used the cash to retire the preferred stock. But such an analysis is directly contrary to a decision of this Court, and its progeny in the lower courts, that the substitution of one issue of securities for another is a continuation of corporate capitalization in altered form. There is accordingly no basis for the court of appeals' division of respondent's unified recapitalization into hypothetical non-existent components.

C

On the facts of this case, it is arithmetically apparent that no discount could arise from the issuance of a $50 debenture in substitution for preferred stock for which $50 has been paid in to the corporation. This arithmetical equivalence is the basis of the decisions of the Court of Claims, which the Tax Court followed in this case. The results of those cases are undeniably sound and approval of their reasoning by

this Court would be sufficient to reverse the judgment below.

Although we subscribe to the results reached in those cases, we believe that in some of its opinions, the Court of Claims has erroneously indicated that discount would arise in the case where preferred stock was issued for less than the face amount of the bond. It does not and should not follow that discount would arise had the preferred stock been issued for less than the face amount of the bond. The many reasons and occasions for the retirement of corporate stock in an amount greater than the issue price are unrelated to compensation for the use or forbearance of money, which this Court has identified as the function of discount. Because of the misconceptions in that aspect of the decisions of the Court of Claims, we do not urge this Court to approve their reasoning. Instead, we have sought reversal here on the broader ground that the substitution of one security for another does not produce deductible bond discount. At all events, the decision below cannot stand.

ARGUMENT

RESPONDENT'S SUBSTITUTION OF ITS 5% DEBENTURES IN THE FACE AMOUNT OF $50 FOR ITS PREVIOUSLY OUTSTANDING $50 PAR, 5% PREFERRED STOCK DID NOT GIVE RISE TO DEDUCTIBLE BOND DISCOUNT

A. INTRODUCTION: THE NATURE OF BOND DISCOUNT

1. Section 163(a) of the Internal Revenue Code, Appendix, *infra*, p. 37, allows a deduction for "all interest paid or accrued within the taxable year on indebtedness." In *Deputy* v. *duPont*, 308 U.S. 488, 498, this Court construed the term "interest on indebt-

edness" to mean "compensation for the use or forbearance of money."

Simply put, bond discount is a form of interest on indebtedness which, although unstated, is in economic terms additional compensation to the bondholder for the use of his money. The prototype transaction where discount arises is one where a corporation receives $950 upon the issuance of its bond in the face amount of $1,000, payable 10 years after issuance. While the bond may have a stated annual interest rate of 5% so that the holder receives $50 per year, the $50 difference between the issue price ($950) and the face amount ($1,000) represents an additional cost to the corporation for the use of the money of $5 per year over the ten-year life of the bond. Accepted accounting practice treats discount as deferred interest.[6]

The Internal Revenue Code and its predecessor Revenue Acts have never explicitly provided for the amortization and deduction of bond discount. However, Article 150 of Treasury Regulations 33 (1918 ed.), relating to the 1916 Revenue Act, and all subsequent Treasury Regulations under the income tax statutes have provided for such amortization and deduction by the issuer of bonds at a discount.[7] Under the 1954 Code, the relevant provision first appeared under the definition of gross income as Treasury Regulations on Income Tax, § 1.61–12(c)(3), Appen-

[6] See, *e.g.*, Finney and Miller, *Principles of Accounting, Intermediate* (6th ed. 1965), p. 263.

[7] The history of the earlier Regulations is set forth in *Montana Power Co.* v. *United States*, 232 F. 2d 541, 546–548 (C.A. 3), certiorari denied, 352 U.S. 843.

dix, *infra,* p. 39. It states: "If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds." Since 1968, this Regulation has appeared under the interest deduction provision as § 1.163–3(a)(1), Appendix, *infra,* p. 40.

The first statutory definition of bond discount appeared as Section 1232(b)(1) of the 1954 Code, Appendix, *infra,* p. 37. It provides that "For purposes of subsection (a), the term 'original issue discount' means the difference between the issue price and the stated redemption price at maturity." Section 1232(b)(2), Appendix, *infra,* pp. 37–39, also first introduced as part of the 1954 Code, defines the term "issue price."[8] As a result of the position taken by these longstanding Treasury Regulations, it is clear that the corporation in the prototype transaction described above would be permitted a bond discount deduction of $5 per year over the ten-year life of the bond.[9]

Decisions of this Court have similarly recognized the nature of bond discount as an additional cost incurred in borrowing money. In considering the early Regulations[10] which described the discount as a "loss" to be "prorated over the life of the bonds sold," the Court in *Helvering* v. *Union Pacific Co.,* 293 U.S. 282, 284–285, referred to discount both as "interest paid

[8] Section 1232(b) was most recently amended by Sec. 5, Interest Equalization Tax Act, P.L. 88–563, 78 Stat. 809, and by Sec. 413(b), Tax Reform Act of 1969, P.L. 91–172, 83 Stat. 487.

[9] See Treasury Regulations on Income Tax (1954 Code), § 1.163–3(b), Example (1), Appendix, *infra,* p. 40.

[10] Treasury Regulations 33, Article 150 (1918 ed.).

for the use of capital procured by a bond issue" and as "a loss resulting from the funding operation * * * which is realized only upon the payment of the bonds at maturity" (293 U.S. at 286). See also *id.* at 287 and *Western Maryland Ry. Co.* v. *Commissioner,* 33 F.2d 695 (C.A. 4). Although the Regulations for a time thereafter classified discount as an interest expense deduction,[11] any characterization was subsequently abandoned.[12]

More recently, in *United States* v. *Midland-Ross Corp.,* 381 U.S. 54, the Court has been unambiguous in its characterization of the nature of discount. It stated (381 U.S. at 57 and 66):

> Earned original issue discount serves the same function as stated interest * * *; it is simply "compensation for the use or forbearance of money."

and that

> despite some expressions indicating a contrary view, this Court has often recognized the economic function of discount as interest.

2. Until the decision of the court of appeals below, it had been generally assumed that whether discount was characterized as an interest expense or as a loss was of no practical significance.[13] Under either

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[11] See, *e.g.*, Arts. 544(3)(a), 563 and 848 of Treasury Regulations 45 (1918 Revenue Act).

[12] See, *e.g.*, Treasury Regulations 111 (1939 Code), § 29.22(a)–17(3)(a).

[13] One of the grounds upon which the court below dismissed the Court of Claims decisions with which it disagreed was that they were based upon the premise that discount arose from loss rather than serving the function of interest. The court of ap-

terminology, a deduction for bond discount serves to reduce the tax liability of the issuing corporation. However, in order for bond discount to arise, there must be an outlay, or an obligation to make an outlay, in excess of the original capital borrowed.

This prerequisite, fundamental to the nature of discount, was the theoretical basis underlying the Court's decision in *Old Mission Co.* v. *Helvering,* 293 U.S. 289. There, the Court concluded that deductible discount on bonds issued by one corporation and held by an affiliate terminated when the corporations filed a consolidated tax return. In so holding, the Court analogized the case to that of a single taxpayer who purchases his own bonds before maturity. Because the obligation to pay the face amount at maturity lapsed, the issuer "could not afterwards deduct, from gross income, the amortized discount on the bonds, in anticipation of their payment at maturity" (293 U.S. at 292).

The foregoing principles similarly govern the question in this case—whether respondent's substitution of its 5% $50 face amount debentures for its previously outstanding $50 par, 5% preferred stock gave rise to deductible bond discount. As we shall demonstrate

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peals variously characterized this premise as "nonapplicable," "erroneous," and "unsound" (Pet. App. B 54, 58, 64). But the Court of Claims simply recognized the historically variant references to discount as loss and as interest, while correctly observing that the difference in terminology made no practical difference. Moreover, the Court of Claims stated that it would nevertheless treat discount as interest. *Erie Lackawanna Railroad Co.* v. *United States*, 422 F. 2d 425, 427–428, n. 7; *Missouri Pacific Railroad Co.* v. *United States*, 427 F. 2d 727, 730, modified, 433 F. 2d 1324, certiorari denied, 402 U.S. 944.

below in Part B, no bond discount arose because the transaction was merely a capital readjustment substituting one security for another. Under such circumstances, respondent incurred no obligation to pay anything in excess of the amount borrowed because of the substitution of securities. In this sense, the case should follow *a fortiori* from the analogy in *Old Mission,* where the obligation to pay an amount in excess of the borrowed capital lapsed upon the issuer's purchase of the bond before maturity. Here, where such an obligation never arose in the first place, there can be no deductible discount.

B. THE SUBSTITUTION BY A CORPORATION OF AN ISSUE OF ITS DEBENTURES FOR AN EXISTING ISSUE OF ITS PREFERRED STOCK IS NOTHING MORE THAN A RECAPITALIZATION WHICH DOES NOT GIVE RISE TO DEDUCTIBLE BOND DISCOUNT

1. The recapitalization did not result in an obligation to pay in excess of an amount borrowed

a. The court of appeals held that respondent's issuance of a debenture for a share of previously outstanding preferred stock gave rise to bond discount equal to the difference between the face amount of the debenture ($50) and the market value of the preferred stock ($33). But the shift from respondent's $50 par, 5% cumulative preferred stock to its 5% subordinated debentures in the face amount of $50 had no major investment significance either to respondent or to its preferred shareholders. The corporate assets were neither increased nor diminished.

To the extent there was any change, it benefited the corporation by giving it a tax deduction under Section 163 for the interest of 5% paid, whereas the 5% divi-

dends on the preferred stock would not have been deductible. The common stockholders, the beneficial owners of the corporation, were benefited by the elimination of the dividend arrearages on the preferred stock and by the elimination of the premium payable on its retirement. Debenture interest was fixed, but dividends on the preferred stock were cumulative, so that both securities would result in equal diminutions of earnings otherwise available for the common stockholders. The debentures were payable on a fixed date eighteen years after issuance, but comparable sinking fund provisions would retire both debentures and preferred stock if there were corporate earnings. The 5% cost of the capital invested in the corporation was the same, whether represented by preferred stock or by debentures.

As has often been noted, the investment difference between preferred stock and unsecured debentures is one of slight degree, and that difference is further diminished when, as here, the debentures are subordinated. Cf. *John Kelley Co.* v. *Commissioner,* 326 U.S. 521. From the standpoint of the preferred shareholders, the conclusion appears inescapable that their interest "was fairly reflected in the highly equivalent characteristics of the debentures into which the preferred [stock] was converted." *Penfield* v. *Davis,* 105 F. Supp. 292, 311 (N.D. Ala.), affirmed, 205 F. 2d 798 (C.A. 5). Under such circumstances, respondent did not, in any realistic sense, issue the $50 debentures at a discount representing the $17 difference between their face ($50) and market ($33) values.

b. The similarity between the terms of respondent's debentures and its previously outstanding preferred stock illustrates the fundamental legal principle governing cases of this type. It is that the substitution by a corporation of one security for another, without more, does not constitute the creation of an obligation to pay in excess of an amount borrowed upon which discount, as a cost of borrowing, can arise. This principle was the basis of Rev. Rul. 59–387, 1959–2 Cum. Bull. 56, in which the Internal Revenue Service ruled that a corporation's issue of its debentures and common stock in exchange for its outstanding preferred stock gave rise to no bond discount, and that the fair market value of the preferred stock was not a relevant factor in this determination. Instead, the transaction was deemed to be merely a capital readjustment in the form of a recapitalization.[14] We believe this Ruling to be correct in its general application and unquestionably sound as applied to the facts of this case.

The recent decision of the Fifth Circuit in *Claussen's, Inc.* v. *United States,* 469 F. 2d 340, where a comparable bond discount claim was rejected, rests upon similar reasoning. There, the taxpayer-corporation issued 6% debentures in the aggregate face amount of $2,250,000, plus new common stock and

[14] Respondent sought and obtained a ruling on whether gain or loss resulted to the corporation, to the common shareholders, and to the preferred shareholders from the recapitalization in this case. (R. 17–21.) No question was raised explicitly concerning bond discount. However, in holding that the preferred shareholders had capital gain or loss from receipt of the debentures (R. 20–21), the ruling necessarily indicated that no discount resulted to the corporation since discount to the corporation would have produced equivalent ordinary income to the recipients of the debentures. Sec. 1232(a)(2)(B).

stock purchase warrants, for previously outstanding common stock. Upon issuance of the original common stock, the corporation received an aggregate of $1,962,500, which had thereafter constituted its capital and paid-in surplus. That amount was also the value of the outstanding stock at the time of the exchange. The court of appeals denied the claim that the $362,500 difference constituted bond discount, pointing out that the corporation had acquired no new capital and that the shareholders had surrendered nothing to the corporation for which there could be a cost of borrowing.[15] On this basis, respondent's claimed bond discount deduction must likewise fail.[16]

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[15] The observations of the Fifth Circuit in *Claussen's* (469 F. 2d at 344, n. 11) are particularly appropriate. "We simply cannot overlook the complete lack of substance to the claims of the corporation here. Its assets were not diminished by a penny, either when the debentures were issued to the stockholders or where the face amount of the bonds was assumed by Fuqua (thus, presumably reducing the amount of the purchase price). The company paid nothing more to the bond-holders at any time than the current interest. It did not sell them to anyone at a discount. It issued them either as dividend, partial distribution of earned income and capital, or as 'boot' in a tax-free reorganization. It cannot deduct as interest what it has not paid out or become liable to pay out to anybody."

The court further noted (469 F. 2d at 344, n. 10) that in a slightly different context, this Court had held that an issue of bonds and stock for previously outstanding stock gave rise to a dividend. *Bazley* v. *Commissioner*, 331 U.S. 737. Cf. Sec. 356(a)(2) and (d) of the Code.

[16] The court of appeals (Pet. App. B 65, n. 7) attempted to distinguish the *Claussen's* case on the factual ground that the exchange was common stock and that the common stockholders' proportional equity was unchanged. While that fact graphically demonstrated that the transaction in *Claussen's* amounted to little more than a simple distribution of bonds, the critical fact, common to this case and *Claussen's*, is that the issuance of the debenture was not accompanied by the acquisition of any new capital.

c. The correctness of the approach in *Claussen's* and the Treasury Ruling can be further demonstrated by the following illustrative example. Suppose respondent, instead of issuing bonds for its outstanding preferred stock, had retired them with cash. When a corporation redeems shares of its stock for cash, the cash distribution gives rise to no deduction either for the par value of the stock, for a call or redemption premium (*John Wanamaker Philadelphia* v. *Commissioner,* 139 F. 2d 644 (C.A. 3); *Jewel Tea Co.* v. *United States,* 90 F. 2d 451 (C.A. 2); *H. and G. Industries, Inc.* v. *Commissioner,* 60 T.C. 163, on appeal to C.A. 3), or because the amount paid in redemption was more than the amount originally paid in for the stock. *Pacific Southwest Realty Co.* v. *Commissioner,* 128 F. 2d 815 (C.A. 9), certiorari denied, 317 U.S. 663. Cf. Secs. 311(a) and 336 of the Code. See also *United States* v. *Cumberland Pub. Serv. Co.,* 338 U.S. 451, 455.

It is therefore clear that had respondent paid its preferred shareholders in cash the $51 to which they were entitled upon the redemption of their preferred shares (R. 192),[17] or the lesser sum of $50, no part of such payment would have been deductible from gross income. But instead of a cash payment, it distributed its obligation for $50, bearing interest at 5%, the same rate at which the same investment had accrued a cumulative right to dividends when it existed in the form of preferred stock. There is

[17] A warrant to subscribe to common stock was distributed and accepted by the preferred shareholders in lieu of their right to dividend arrearages of $10 (R. 56–57, 192).

nothing to suggest that respondent was paying more than the stated rate of 5% as compensation for the use or forbearance of money (*United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 57), and everything to indicate that the stated interest rate of 5% was respondent's entire obligation for the privilege of deferring payment. The fact that a few hundred shares of preferred stock had changed hands at prices lower than $50 in sporadic sales over a period of months (R. 167) does not indicate that the holders of all or of the required two-thirds (R. 176) of the 47,059 shares of preferred stock outstanding would have accepted less than $50 per share when respondent's directors proposed to retire the entire issue.

Since respondent would have obtained no deduction had it retired its preferred stock for $50 per share in cash, is it possible for it to produce a deduction of $17 per debenture by simply substituting its $50 interest-bearing obligation for $50 cash? The answer, we submit, is plainly no. The market value of the preferred stock for which the bonds were substituted can therefore have no relevance in determining the existence of discount.

2. The transaction is not analogous to the issuance of bonds for property because there was no acquisition of property

In holding that respondent was entitled to its claimed deduction for bond discount, the court below assimilated the transaction to one where bonds are issued for property without an agreement as to the purchase price of the property. With respect to this question, there was a pre-existing conflict of decisions as to the existence of discount in such a transaction (Pet.

App. B 59–64). By reasoning from such an analogy, the court disregarded the settled principle that a corporation's retirement of its own stock is not an acquisition of property. Thus, whatever the merits of the bonds-for-property question, which has now been settled by legislation for years after 1969 (see p. 23, n. 25, *infra*), it need not be resolved in this case. Nevertheless, in order fully to explain the analogy which led the court below into error, a brief description of the history of the bonds-for-property question is appropriate.

a. Where bonds are issued for cash, there are relatively few problems in determining whether discount exists and, if so, its amount.[18] Where bonds equal in face amount to the agreed purchase price of property are issued in payment of the price, the courts have long held that no discount arises and have refused to impute interest where the parties have not provided for it in their contract.[19] If the parties had agreed

[18] The question of the existence of discount on convertible obligations issued for cash at par is currently in litigation. *Hunt Foods and Industries, Inc.* v. *Commissioner*, 57 T.C. 633, on appeal to C.A. 9. Cf. *Chock Full O'Nuts Corp.* v. *United States*, 453 F. 2d 300 (C.A. 2); *AMF Incorporated* v. *United States*, 476 F. 2d 1351 (Ct. Cl.), petition for certiorari pending, October Term, 1973, No. 73–73.

[19] *United States* v. *Cornish*, 348 F. 2d 175 (C.A. 9); *Paine* v. *Commissioner*, 236 F. 2d 398 (C.A. 8); *M. C. Parrish & Co.* v. *Commissioner*, 147 F. 2d 284 (C.A. 5); *Elliott Paint & Varnish Co.* v. *Commissioner*, 44 B.T.A. 241.

Section 483 of the Internal Revenue Code of 1954, as added by Section 224(a) of the Revenue Act of 1964, P.L. 88–272, 78 Stat. 19, now permits the imputation of interest in any contract for the sale or exchange of property where the deferred sales price does not provide for interest or the interest rate is inadequate. It is effective only for payments made after December 31, 1963, on account of sales or exchanges of property occurring after June 30, 1963. The legislative history reflects

that the purchase price of property was $950, but the corporate purchaser issued its bond for $1,000 to acquire it, presumably there would be a $50 discount, and the cost of the property to the purchaser would be $950 for purposes of computing gain or loss upon subsequent disposition, or for purposes of depreciation.

The courts have disagreed, however, on the question whether discount arises in the case where the purchaser agrees that it will issue its bond in a stated amount, *e.g.*, $1,000, to acquire the property purchased without any agreement as to the purchase price. It appears, at least *prima facie,* that the cost of the property is $1,000 for computing gain or loss to the purchaser upon disposition, or for depreciation, and that accordingly no discount arises upon the transaction. The Court of Claims [20] and the Board of Tax Appeals [21] have held that this is the necessary result of the transaction, not only *prima facie,* but conclusively.

On the other hand, a divided Third Circuit had held to the contrary in *American Smelting & Refining Co.* v. *United States,* 130 F. 2d 883. There, where the property acquired by the taxpayer consisted of securities of its subsidiary which were traded on the

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that it represented a change in existing law. H. Rep. No. 749, 88th Cong., 1st Sess., pp. 72–74; S. Rep. No. 830, 88th Cong., 2d Sess., pp. 101–104. *United States* v. *Cornish, supra.*

[20] *Southern Natural Gas Co.* v. *United States,* 412 F. 2d 1222 (Ct. Cl.); *Montana Power Co.* v. *United States,* 159 F. Supp. 593 (Ct. Cl.).

[21] *Sacramento Medico Dental Building Co.* v. *Commissioner,* 47 B.T.A. 315.

New York Stock Exchange, that court concluded that it was open to demonstration that the price of the property (and cost to the buyer) was, to employ the example above, $950, despite the fact that it was acquired by the issuance of a bond in the principal amount of $1,000. If this demonstration were made, the court held that the $50 difference between the $950 cost of the property and the $1,000 face amount of the bond would constitute discount.[22] In view of the Third Circuit's subsequent *en banc* decision in *Commissioner* v. *Danielson*, 378 F. 2d 771, holding that courts should not permit a taxpayer to vary the agreed terms of a written purchase contract in order to reallocate cost and consideration for tax purposes, it is unlikely that it would now follow its *American Smelting* decision. Nevertheless, the Tenth Circuit did follow it in *Atchison, Topeka and Santa Fe R.R.* v. *United States*, 443 F. 2d 147, while noting (443 F. 2d, at 152) that its decision related to a pre-1913 transaction, when tax considerations would not have affected both buyer and seller.[23]

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[22] In a subsequent *en banc* decision, two judges of the Third Circuit noted their disagreement with the *American Smelting* ruling and one judge (who had been in the majority in *American Smelting*) adhered to his prior view. The majority of the court, however, found it unnecessary to decide the question. *Montana Power Co.* v. *United States*, 232 F. 2d 541, 545–550, 550–554 (C.A. 3), certiorari denied, 352 U.S. 843.

[23] Though *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39 (C.A. 2) is frequently cited in this connection (Pet. App. B. 60, n. 6), we believe that the Second Circuit is not a participant in this disagreement. In that case the designated face amounts of notes, otherwise non-interest bearing prior to maturity, increased with the passage of time. The periodic increase on the

b. Whatever the merits of the bonds-for-property question,[24] settled by legislation for years after 1969,[25] its resolution is not necessary in this case. When respondent eliminated its $50 par, 5% cumulative preferred stock, and substituted therefor its 5% debentures in the face amount of $50, it did not acquire any property or any new assets. The question of discount on a bonds-for-property exchange therefore did not arise. In purporting to follow and apply its previous decision in *Atchison, Topeka,* which relied in turn upon the questionable *American Smelting* holding (Pet. App. B 59-64), the court below misconceived the transaction before it.

The fundamental error of the court below was to view respondent's cancellation of its preferred stock as an acquisition of property in the usual sense. But when a corporation distributes money or property to a

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face of the notes could easily be recognized as interest or its discount equivalent.

[24] We believe the opinion of Judge Kalodner in *Montana Power* and the opinions of the Court of Claims, *supra*, are the more persuasive.

[25] As amended to apply to bonds issued after May 27, 1969, Section 1232(b)(2), Appendix, *infra*, pp. 37-39, provides, with several stated exceptions, that the issue price of a bond which is issued for property is the face amount. Hence, there would be no discount. The exceptions relate to bonds traded on an established securities market and to bonds issued for stock or securities which are traded on an established securities market. See Section 1232(b)(2) (A) and (B), Appendix, *infra*, p. 38. Under these circumstances, the issue price would be the fair market value of the property and discount equal to the difference between that value and the face amount of the bond would arise.

shareholder who surrenders his shares of corporate stock, it acquires no property. "[S]ince a corporation's own shares are not assets, but only the convenient machinery for evidencing shareholder interests, it is a fallacy to say it has received anything * * *." *Houston Brothers Co.* v. *Commissioner,* 21 B.T.A. 804, 815. See also *375 Park Avenue Corp.* v. *Commissioner,* 23 B.T.A. 969, 973; *Johnson* v. *Commissioner,* 56 F. 2d 58 (C.A. 5); and *Claussen's, Inc.* v. *United States,* 469 F. 2d 340, 344 (C.A. 5). Cf. Section 317(a) of the Code. Moreover, generally accepted accounting practice has recognized the principle, since it does not treat treasury stock as an asset. See Wixson, Kell and Bedford, *Accountants' Handbook* (5th ed. 1970), p. 21.31.

Similarly, where, as here, a corporation substitutes one issue of securities for another, it receives no property upon cancellation of the old security. Such a transaction is, as respondent's directors characterized it (R. 56), a recapitalization, or as this Court described it, a "reshuffling of a capital structure, within the framework of an existing corporation." *Helvering* v. *Southwest Corp.,* 315 U.S. 194, 202. Under the Internal Revenue Code, such a transaction is not regarded as an acquisition of property by the corporation with respect to which the usual rules of gain or less apply. To the contrary, it is treated as a simple adjustment to the capital structure of the corporation, not giving rise to income or deduction to the corporation. *Commissioner* v. *Capento Securities Corp.,* 140 F. 2d 382 (C.A. 1); Rev. Rul. 59–222, 1959–1 Cum. Bull. 80.

Even when a corporation acquired shares of its own stock, held the shares as treasury stock, and later

reissued them at a price greater than it had paid to acquire the shares, gain was recognized to the corporation, prior to 1954, only in limited circumstances where the corporation had dealt in its own shares as it might in the shares of another corporation. *Helvering* v. *Reynolds Co.*, 306 U.S. 110; *United States* v. *Anderson, Clayton & Co.*, 350 U.S. 55. Since 1954, gain under even such limited circumstances has been eliminated by Section 1032 of the Internal Revenue Code of 1954.

Moreover, even the restricted concept of property made applicable in limited circumstances to treasury shares prior to 1954 would not have been applicable to respondent's preferred shares. While the preferred issue was outstanding, any shares redeemed could not be re-issued; they would be cancelled, and the number of authorized shares correspondingly reduced (R. 196). In 1957, by vote of its directors and shareholders, respondent simply eliminated its preferred shares by amendment of its certificate of incorporation pursuant to 8 Del. Code Ann., Section 242. As the shareholders were informed (R. 176), this elimination was not a matter of choice or bargaining by the individual shareholder, but took place by operation of law. *Goldman* v. *Postal Telegraph, Inc.*, 52 F. Supp. 763 (D. Del.); *Morris* v. *American Public Utilities Co.*, 14 Del. Ch. 136, 122 Atl. 696.

Under no circumstances could respondent be viewed as dealing in its own shares as it might in the shares of another corporation. No such dealing was possible since the preferred stock was cancelled immediately

upon acquisition. Thus, even if the *American Smelting* rationale for bond discount were accepted, it could not apply here since respondent acquired no property when it eliminated its preferred stock.

3. The transaction cannot be analogized to the issuance of $50 face amount debentures for $33 in cash and the subsequent retirement of the preferred stock for $33 per share

The court below further rationalized its result by assimilating respondent's substitution of its debentures for its preferred stock to a transaction in which respondent had issued its $50 debentures for $33 cash, and then used the cash to retire the preferred stock at $33 per share (Pet. App. B 53–55). Under this analysis, the court below observed that (Pet. App. B 55) "[t]he picture looks quite different when the result is thus broken down." We submit that such a division of respondent's unified transaction into the suggested non-existent hypothetical components would not produce the result anticipated by the court below.

It is the transaction actually accomplished by respondent and not some speculative variation, that the court had to pass upon. As the Second Circuit has observed, "It would be quite intolerable to pyramid the existing complexities of tax law by a rule that the tax shall be that resulting from the form of transaction taxpayers have chosen or from any other form they might have chosen, whichever is less." *Television Industries, Inc.* v. *Commissioner,* 284 F. 2d 322, 325.

At all events, the hypothetical example has neither a factual nor legal basis. Factually, there is nothing in the record to establish the price at which respondent

would have been able to issue its debentures, had it sought to sell them for cash. And, as we have noted, a few sporadic sales of small lots of preferred shares do not establish, or even suggest, that all, or even a majority, of the preferred shareholders would have accepted $33 per share when respondent proposed retiring the entire issue. The intention of management to retire an issue of preferred stock will of course, when known, move a lower market price up to or toward the redemption price.

But quite apart from the factual deficiencies of the court's speculative discussion, its assimilation of a substitution of one issue of securities for another to a two-step issue-for-cash-plus-cash-redemption flies squarely in the face of this Court's unanimous rejection of such a contrary-to-fact analysis in *Great Western Power Co.* v. *Commissioner,* 297 U.S. 543, 546–547. There, the Court held that for purposes of determining the existence and amount of discount upon the substitution or exchange of one issue of securities for another, the transaction must be viewed as a continuum, and could not be assimilated to the sale of one issue for cash and the retirement of the other with the proceeds. The lower courts have followed and applied this decision. See, *e.g., Chicago, Milwaukee, St. Paul & Pacific R. Co.* v. *United States,* 404 F. 2d 960 (Ct. Cl.); *Bridgeport Hydraulic Co.* v. *Commissioner,* 22 T.C. 215; *South Carolina Continental Telephone Co.* v. *Commissioner,* 10 T.C. 164. Cf. *Commissioner* v. *Capento Securities Corp., supra,* 140 F. 2d at 385–387. The clear impact of these decisions, which the court below disregarded, refutes its two-step analysis of re-

spondent's substitution of debentures for preferred stock, The court's ultimate finding of discount, which rests upon such discredited reasoning, must similarly be rejected.

C. NO DISCOUNT COULD ARISE UPON RESPONDENT'S SUBSTITUTION OF A $50 DEBENTURE FOR A SHARE OF PREFERRED STOCK FOR WHICH IT HAD PREVIOUSLY RECEIVED $50

In upholding the deficiencies determined by the Commissioner, the Tax Court followed a series of recent decisions of the Court of Claims.[26] These cases, as applied to the transaction at issue, held that no discount could arise when respondent substituted a debenture in the face amount of $50 for a share of its $50 par preferred stock for which it had received $50 upon issuance.[27] In view of this Court's *Great Western* holding that the substitution of one security issue for another constitutes a continuum for purposes of determining the existence and computation of discount, the Tax Court was correct as a matter of simple arithmetic computation. There can be no discount when a corporation receives $50 and issues its obligations in the face amount of $50.

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[26] *Erie Lackawanna Railroad Co.* v. *United States*, 422 F. 2d 425; *Missouri Pacific Railroad Co.* v. *United States*, 427 F. 2d 727, modified, 433 F. 2d 1324, certiorari denied, 402 U.S. 944; *St. Louis-San Francisco Railway Co.* v. *United States*, 444 F. 2d 1102, certiorari denied, 404 U.S. 1017.

[27] It has been assumed throughout that respondent's $50 par preferred stock was issued for at least $50 per share, and nothing in the record suggests that it was issued for less. Under Delaware law, the shares could not have been issued for less. *Yasik* v. *Wachtel*, 25 Del. Ch. 247, 254, 17 A. 2d 309, 312.

Under the decision of the Tax Court in this case and those of the Court of Claims, the arithmetical equivalence between the face amount of the debenture and the amount originally obtained upon the issuance of the preferred stock is sufficient to negate the existence of discount. We believe that the rejections of the bond discount claims in those cases are correct in result. An adoption by this Court of the reasoning of those decisions would therefore be adequate for the disposition of this case to require reversal of the judgment below.

It is our position, however, that the arithmetical equivalence relied upon by the Tax Court and the Court of Claims is a misleading basis for the rejection of a bond discount claim in cases of this type.[28] Accordingly, we have urged in Part B, supra, a broader basis of decision: that a capital readjustment in the form of a recapitalization of this type does not give rise to bond discount. But since the Court may reach the theory of arithmetical equivalence, we explain why we consider certain aspects of the decisions announcing and applying that principle to be erroneous.

In *Erie Lackawanna Railroad Co.* v. *United States*, 422 F. 2d 425 (Ct. Cl), the taxpayer-corporation exchanged its $100 debentures for its shares of $100 par preferred stock. The Court of Claims held that no discount could arise on the issuance of the $100 debentures since the corporation had received $100 upon the

[28] The Fifth Circuit noted its doubt as to the basis of those decisions in *Claussen's, Inc.* v. *United States*, 469 F. 2d at 342–343.

issuance of each share of preferred stock. It explicitly left undecided what the result would have been had the preferred shares been issued for less than $100 (422 F. 2d at 430). Subsequently, in *Missouri Pacific Railroad Co.* v. *United States,* 427 F. 2d 727 (Ct. Cl.), the facts with respect to several bond issues paralleled those of *Erie Lackawanna,* and the Court of Claims followed its earlier decision. There were, however, two issues of bonds exchanged for outstanding securities, where the security first issued had been issued for less than the face amount of the bonds issued in exchange. As to these exchanges, the court found discount in the amount of the difference (427 F. 2d at 733–734).

On rehearing, the Court of Claims modified its decision with respect to these two bond issues. The change adopted was to approve the rationale of the intervening district court decision in *Cities Service Co.* v. *United States,* 316 F. Supp. 61 (S.D. N.Y.), reaffirmed, 330 F. Supp. 421, supplemental opinion, 362 F. Supp. 830,[29] which held that upon such an exchange of bonds for previously issued securities, discount, if any, was the difference between the face amount of the bonds and the greater of: (a) the amount for which the prior securities had been issued or (b) the value to the corporation of the previously issued securities at the time of the exchange.[30] 433

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[29] Final judgment has not yet been entered in this case.

[30] Under the *Cities Service* formula, the value to the corporation of the original securities might be greater but never less than the amount for which they were originally issued (316 F. Supp. at 72). Thus, the latter amount constitutes a floor for purposes of measuring discount.

F. 2d 1324. Applying this *Cities Service* formula, the Court of Claims found on rehearing in *Missouri Pacific* that the value of the prior securities to the corporation was equal to the face amount of the bonds, and that hence, no discount arose (433 F. 2d at 1325–1326). The court stated that there was a difference between the terms "value to the corporation" and "fair market value" (433 F. 2d at 1326). Finally, in *St. Louis-San Francisco Railway Co.* v. *United States,* 444 F. 2d 1102, where the facts paralleled those of *Erie Lackawanna,* the court explicitly differentiated between the two terms (444 F. 2d at 1105–1106). However, it never indicated the precise meaning of the concept "value to the corporation."[21] Whatever its meaning might be, we do not believe that either the issue price of stock or its "value to the corporation" can contribute a valid measure for the determination of discount upon a recapitalization.

If we assume that the latter term means the amount which the corporation agrees to pay for the stock, no discount could exist because the face amount of the debenture will, at all times, be equal to the value of the stock "to the corporation." And though, as a matter of simple arithmetic, discount cannot exist if a corporation issues stock for $50 and then substitutes a $50 obligation for each share of stock, it by no means follows, as the *Cities Service* formula suggests, that discount does arise if the substituted obligation is issued in the face amount of $55.

[21] In *Cities Service*, the district court similarly differentiated between the two terms. In determining the value to the corporation of the preferred stock, it stated that its fair market value was "relevant" but not "conclusive" (316 F. Supp. at 73).

There are many circumstances that will lead to a corporation's redeeming shares of stock for more than was paid in upon issuance. A share of $50 par preferred issued for $50 may have a call or redemption price of $55. A share of no-par preferred may have been issued for $40, but have a right prior to the common to $50 upon liquidation or redemption. A share of common stock, or of participating preferred, may have been issued for $50, but growth of the enterprise may have increased the shareholder's equity to $60 or more per share.

As we have previously pointed out, the corporation would not be entitled to any deduction if it paid cash to redeem these shares at the higher figure. There is no reason why issuing its interest-bearing obligation [22] in the face amount of the cash it might and would otherwise have paid, should convert the non-deduction into a deduction. Since discount serves the function of interest, or compensation for the use or forbearance of money (*United States* v. *Midland-Ross Corp.*, 381 U.S. 54, 57), an obligation in the face amount of the redemption price that would otherwise have been paid in cash refutes rather than supports the presence of discount, whatever may have been the original issue price.

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[22] If a share of $50 par preferred stock, issued for $50, had a call price of $55, and the corporation upon call did not pay cash, but delivered its *non-interest-bearing* obligation, payable two years from date, in the face amount of $60, there might be a strong factual inference that the $5 difference between the call price and $60 was interest, or discount. But prior to the enactment of Section 483 (see n. 19, *supra*) the courts have consistently refused to impute interest in such circumstances.

Conversely, if the term "value to the corporation" is not identical with the amount the corporation agrees to pay, it will still not be able to establish or measure interest or discount in such a transaction. There are many reasons set forth in the reported decisions why a corporation may wish to convert an issue of stock into obligations, either by voluntary exchange or by shareholders' vote. It may seek the tax deduction that the payment of interest, but not of dividends, will give. See, *e.g.*, *Schoo* v. *Commissioner*, 47 B.T.A. 459. It may seek to eliminate a dissident minority. See, *e.g.*, *Hickok* v. *Commissioner*, 32 T.C. 80. It may seek to shift the equity position from a retired former management group to the current management. See, *e.g.*, *Wolf Envelope Co.* v. *Commissioner*, 17 T.C. 471. It may wish to eliminate dividend arrearages. See, *e.g.*, *Seide* v. *Commissioner*, 18 T.C. 502.

To accomplish these or other purposes, it may be necessary to offer a price greater than market or some amount more vaguely ascertained as "value to the corporation" in order to obtain consent, though it would appear that the price it offers is the best and conclusive evidence of value to the corporation. But whatever elements may enter into the determination of the face amount of its obligations that the corporation may decide to offer in substitution for outstanding stock, there is nothing in any of these cases that would support imputing to the face amount of the obligation an element of compensation for the use or

forbearance of money, particularly where the obligation is itself interest-bearing.[33]

[33] The claim of discount in *Gulf, Mobile and Ohio Railroad Co.* v. *United States*, 339 F. Supp. 489 (S.D. Ala.), final decision, 31 A.F.T.R. 2d 73–436, on appeal to C.A. 5, furnishes an example of the uncertain results of the application of the Court of Claims' theories for ascertaining discount. In 1957, the corporation sought and obtained authorization from the Interstate Commerce Commission as required by Section 20a of the Interstate Commerce Act (49 U.S.C. 20a), to issue 5% income debentures in exchange for its outstanding $5 preferred stock. The stated purpose of the proposed exchange, and the basis for authorization, was the tax advantage of the interest deduction. After issuing the debentures in lieu of the previously outstanding preferred stock, the corporation then claimed a deduction for discount.

Purporting to follow the Court of Claims' decisions, the district court upheld the claim for discount and made its own decision on the value of the property received for the preferred in 1940 shortly after the corporation was organized. But in so doing, it disregarded the valuation and authorization of capitalization by the Interstate Commerce Commission (*Gulf, Mobile & Ohio Railroad Company Merger*, 236 I.C.C. 61), as required by Sections 5(2) and 20a of the Interstate Commerce Act (49 U.S.C. 5(2) and 20a). Cf. *Atlanta, B. & C. Ry. Co.* v. *United States*, 296 U.S. 33; *New York, Chicago & St. Louis R. Co.* v. *Frank*, 314 U.S. 360, 365. It found discount measured by the difference between the market value of the preferred stock at the time of the exchange and the face amount of the debentures, notwithstanding the fact that the Court of Claims has specifically rejected market value of the outstanding security as a criterion for measuring discount. By joint motion, the proceedings on appeal in the Fifth Circuit have been deferred to await the Court's decision in this case.

Compare the similar disregard by the district court in *Cities Service Co.* v. *United States*, *supra*, 316 F. Supp. at 66–69, of the valuation and capitalization approved by the Securities and Exchange Commission.

CONCLUSION

For the reasons stated, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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NOVEMBER 1973.

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

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SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

* * * * *

(b) *Definitions.*—

(1) *Original issue discount.*—For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time.

(2) [as amended by Sec. 5, Interest Equalization Tax Act, P.L. 88-563, 78 Stat. 809, and Sec. 413(b), Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 487] *Issue price.*—In the case of issues of bonds or other evidences of indebtedness registered with the Securities and Exchange Commission, the term "issue price" means the initial offering price to the public (excluding bond houses and brokers) at which price a substantial amount of such bonds or other evidences of indebtedness were sold. In the case of privately placed issues of bonds or

other evidence of indebtedness, the issue price of each such bond or other evidence of indebtedness is the price paid by the first buyer of such bond increased by the amount, if any, of tax paid under section 4911 (and not credited, refunded, or reimbursed) on the acquisition of such bond or evidence of indebtedness by the first buyer. For purposes of this paragraph, the terms "initial offering price" and "price paid by the first buyer" include the aggregate payments made by the purchaser under the purchase agreement, including modifications thereof. In the case of a bond or other evidence of indebtedness and an option or other security issued together as an investment unit, the issue price for such investment unit shall be determined in accordance with the rules stated in this paragraph. Such issue price attributable to each element of the investment unit shall be that portion thereof which the fair market value of such element bears to the total fair market value of all the elements in the investment unit. The issue price of the bond or other evidence of indebtedness included in such investment unit shall be the portion so allocated to it. In the case of a bond or other evidence of indebtedness, or an investment unit as described in this paragraph (other than a bond or other evidence of indebtedness or an investment unit issued pursuant to a plan of reorganization within the meaning of section 368(a)(1) or an insolvency reorganization within the meaning of section 371, 373, or 374), which is issued for property and which—

(A) is part of an issue a portion of which is traded on an established securities market, or

(B) is issued for stock or securities which are traded on an established securities market,

the issue price of such bond or other evidence of indebtedness or investment unit, as the case

may be, shall be the fair market value of such property. Except in cases to which the preceding sentence applies, the issue price of a bond or other evidence of indebtedness (whether or not issued as a part of an investment unit) which is issued for property (other than money) shall be the stated redemption price at maturity.

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Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.61–12 [as republished in T.D. 6500, 25 Fed. Reg., Part 11, pp. 11402, 11442–11443] *Income from discharge of indebtedness.*

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(c) *Sale and purchase by corporation of its Bonds.* * * *

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(3) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is income for the taxable year.

* * * * *

§ 1.163–3 [as amended by T.D. 6984, 1969–1 Cum. Bull. 38] *Deduction for bond discount.*

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond (as defined in paragraph (b)(2) of § 1.1232–3).

* * * * *

(b) *Examples.* The rules in paragraph (2) of this section are illustrated by the following examples:

Example (1). M Corporation, on January 1, 1960, the beginning of its taxable year, issued for $95,000, 3 percent bonds, maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. M Corporation should treat $5,000 ($100,000−$95,000) as the total amount to be amortized over the life of the bonds.

* * * * *

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